2

Regional Trade and Preferential Trading Agreements: A Global Perspective

In the last four decades, developing countries have burst onto the global marketplace. Their share of global trade increased from about one-fifth in 1960 to about one-third in 2004—at a time when global trade as whole was increasing to unprecedented levels. In every region, exports have outpaced the growth of output and increased as a share of GDP. Three rounds of multilateral trade negotiations combined with structural economic reforms undertaken throughout the world ushered in the sustained reduction in border protection that made this growth possible. The World Trade Organization (WTO), formed in 1994, consolidated an evolving system of rules based on nondiscrimination among trading partners—a cornerstone of the multilateral system.

Today a second trend in the trading system is rapidly gaining momentum and establishing a very different set of rules. This new trend is the proliferation of regional and bilateral trade agreements (RTAs)—agreements among a group of countries that reduce barriers to trade on a reciprocal and preferential basis for those in the group. The number of these agreements has more than quadrupled since 1990, rising to around 230 by late 2004.[1] Trade between RTA partners now makes up nearly 40 percent of total global trade, and new agreements increasingly address issues beyond trade. The value of preferences has steadily fallen, however, as most countries have been reducing tariffs across the board to all partners on a most favored nation, or nondiscriminatory (MFN) basis, at the same time as they have been eliminating barriers preferentially through RTAs. In fact, roughly 66 percent of the decline in average tariffs in developing countries during the last two decades has come from unilateral reductions, as distinct from 25 percent coming out of the Uruguay Round and around 10 percent from RTAs. Moreover, product exclusions and restrictive rules of origin further limit the trade-expanding effects of preferences. Nonetheless, the result of this proliferation is an increasingly complex global trading system where different countries' access to a given market are often governed by very different sets of rules.

This chapter charts the rise of RTAs, examines the different motivations countries have for pursuing RTAs, and draws attention to the complexity they generate. It then describes the evolution of regional trading patterns and shows how the major developing regions differed strikingly in their timing of integration, their pace of export growth, their policies toward import competition and foreign investment, and the impact of regional trading arrangements. It concludes that those regions that aspired to trade most with the global economy became the most regionally integrated as well. Further, regional trade tends to precede preferential trade agreements rather than the other way around.

Box 2.1 RTAs and types of trade liberalization

Following WTO convention, the term *regional trade agreement* encompasses both reciprocal bilateral free trade or customs areas and multicountry (plurilateral) agreements. Regional and bilateral trade agreements provide for one type of trade liberalization, and they must be seen in a broader context of alternative methods of liberalization. Members of RTAs liberalize trade on a *reciprocal and preferential* basis. While programs such as the U.S. African Growth and Opportunity Act (AGOA) and the EU's Everything But Arms (EBA) also liberalize trade preferentially (i.e., different trade partners receive different treatment), the United States and EU extend these preferences *unilaterally* rather than reciprocally. In contrast to both of these types of preferential liberalization, countries often lower trade barriers in a *nondiscriminatory* fashion for all trade partners. They might do so *multilaterally*—through GATT/WTO negotiating rounds—or *autonomously,* as in the case of Pakistan in the late 1990s. The matrix below illustrates this taxonomy of liberalization methods.

RTAs are commonly divided into several basic categories, according the degree of economic integration they provide. The canonical taxonomy of RTAs contains the following four levels of integration:

1. In a *Free Trade Area,* members eliminate barriers to trade in goods (and increasingly services) among members, but each member is free to maintain different MFN barriers on nonmembers. This latter characteristic requires members to develop rules of origin to prevent imports from third countries from being transshipped through the member country with the lowest tariffs.

2. A *Customs Union* moves beyond a free trade area by establishing a common external tariff on all trade between members and nonmembers. Customs unions typically contain mechanisms to redistribute tariff revenue among members.

3. A *Common Market* deepens a customs union by providing for the free flow of factors of production (labor and capital) in addition to the free flow of outputs.

4. In an *Economic and Monetary Union,* members share a common currency and macroeconomic policies.

The international experience with RTAs is much richer than this simple taxonomy suggests. NAFTA andother more recent agreements establishing free trade areas contain provisions governing domestic labor standards and other regulatory issues, which one traditionally associated with agreements for deeper integration. On the other hand, many free trade agreements exclude important categories of goods (notably agriculture) from trade liberalization. In some cases customs unions still levy tariffs on trade between members.

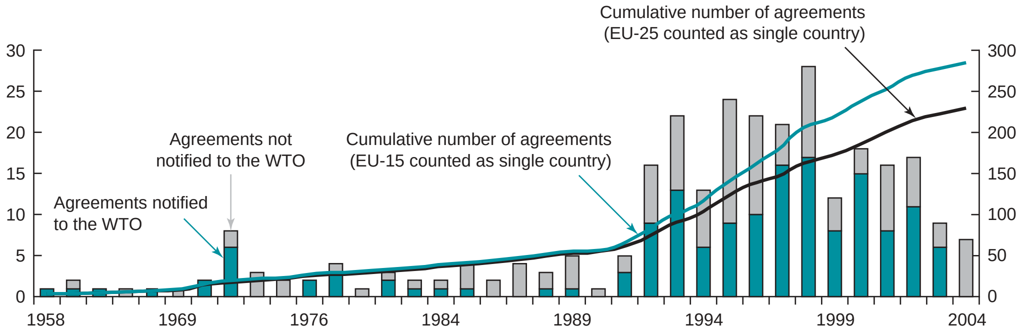
	Method of implementation	
Scope of beneficiaries	**Reciprocal**	**Unilateral**
Preferential: selected countries	NAFTA, EU, COMESA, EPAs, and other RTAs	GSP, AGOA, EBA, Cotonou
Nondiscriminatory (MFN): all countries	GATT/WTO multilateral agreements	Autonomous liberalization

Source: World Bank staff.

The Proliferation of Regional Preference Systems

More agreements are being signed. Since 1990, the number of RTAs in force rose from 50 to nearly 230 (figure 2.1). The WTO estimates that another 60 agreements are in various stages of negotiation. The boom in RTAs reflects changes in certain countries' trade policy objectives, the changing perceptions of the multilateral liberalization

Figure 2.1 Number of RTAs exploded in the 1990s



Sources: WTO data and WTO staff.

process, and the reintegration into the global economy of countries in transition from socialism. This last category accounts for many of the new agreements signed in the early 1990s, when countries in Eastern Europe and the former Soviet Union negotiated RTAs with Western Europe [both the EU and the European Free Trade Association (EFTA)] and with each other.

Some of the RTAs included in figure 2.1 have never been reported to the WTO, for any of several reasons. One reason is that the WTO does not enforce notification (the same is true of notification requirements in other WTO agreements). Another is that several countries that have yet to join the WTO have been quite active in forming RTAs. Russia, for example, is in the process of joining the WTO and has signed bilateral free trade agreements (FTAs) with other members of the Commonwealth of Independent States (CIS). It is also pursuing two regional arrangements that are designated to become customs unions: the Euroasian Economic Community and the Single Economic Space. Because a consistent data source covering all RTAs is lacking, data are based on the information contained in the WTO database, supplemented by data from the major unreported agreements.

Most countries are participating

Nearly all countries belong to at least one RTA,[2] and some are party to numerous agreements (table 2.1). On average, each country belongs to six RTAs, though there is considerable variation across regions and levels of development. East Asian countries sign fewer agreements than countries in other regions. Northern countries have participated to the greatest extent, each signing, on average, 13 agreements. A substantial

Box 2.2 Reporting RTAs to the WTO

RTAs represent a fundamental departure from the core WTO principle of nondiscrimination. Nonetheless, the WTO affords its members a large degree of flexibility in entering new RTAs. Within the WTO mandate, countries may join agreements by meeting the requirements of the General Agreement on Tariffs and Trade (GATT) Article XXIV covering the formation of customs unions and free trade areas in merchandise trade; the General Agreement on Trade in Services (GATS) Article V on agreements in services; or the Enabling Clause (the 1979 Decision on Differential and More Favorable Treatment, Reciprocity, and Fuller Participation of

(Box continues on next page)

Box 2.2 *(continued)*

Developing Countries) dealing with trade in goods between developing countries.

Countries are required to notify the WTO secretariat of any RTAs they enter into, and their provisions are subject to review by the WTO. However, the review process in practice ends with the committee's queries of the parties and has not led to a subsequent report to the membership or formal WTO endorsement in any case. Furthermore, even the notification requirement, though a formal rule, has enjoyed only inconsistent compliance. An examination of the WTO RTA database reveals very large gaps between the date agreements are signed and the date they are reported to the WTO. Several agreements with WTO members have yet to be reported to the organization. These include the Greater Arab Free Trade Area, the Aghadir Agreement in the Middle East and North Africa, the India-Nepal and India-Bhutan agreements in South Asia, and several agreements in Africa. Some agreements, such as EU accessions, are reported more than a year in advance, while other agreements are notified six or more years after entry into force. The average gap is 354 days. Excluding agreements notified before signature, the average gap rises to 446. The median delays between entry into force and notification are 135 and 188 days, respectively.

Sources: World Bank and WTO staff.

Table 2.1 Most countries belong to more than one RTA

	East Asia and Pacific	Europe and Central Asia	Latin America and the Caribbean	Middle East and North Africa	South Asia	Sub-Saharan Africa	North	Total
Number of countries	32	36	39	21	8	48	25	209
North-South bilateral								
Countries belonging to at least one RTA	4	12	6	10	0	2	10	44
Average number of RTAs per country	2	1	2	1		1	4	2
Maximum number of RTAs per country	4	4	4	3	0	1	24	24
All others								
Countries belonging to at least one RTA	24	22	33	20	8	47	10	164
Average number of RTAs per country	2	6	8	5	4	4	8	5
Maximum number of RTAs per country	3	12	17	12	9	9	15	17
Total								
Countries belonging to at least one RTA	26	26	35	20	8	48	11	174
Average number of RTAs per country	2	6	8	5	4	4	11	5
Maximum number of RTAs per country	7	12	19	13	9	9	29	29

Note: Bilateral agreements are defined as an RTA with two members. North is OECD 24 plus Lichtenstein, and South is all other countries.
Source: Published WTO data, World Bank staff.

number of developing countries (45) have signed bilateral preferential agreements with a Northern partner. However, this activity is not spread evenly across regions. Most activity has been in Eastern Europe, Northern Africa, and Latin America. There are no countries in South Asia that have signed a bilateral agreement with a Northern partner. The enlargement of the EU in May 2004 led to a fall in the number of North-South RTAs in Europe.

Since 2000, several major new trends have emerged in the pattern of regional trade agreements. One unifying characteristic is that these take RTAs well beyond agreements between adjacent countries. For example,

- The EU's move toward bilateral market access FTAs and Economic Partnership Agreements (EPAs) with the ACP countries;
- The shift in the U.S. position toward bilateral preferential agreements; and
- The effort of a handful of developing countries to open markets through RTAs.

We turn now to a more in-depth investigation of these trends.

EU Preferential Trade Arrangements

During the 1990s, the EU was an active sponsor of bilateral arrangements with individual countries and groups of countries and was the major player in the RTA game. Prior to the recent accession of 10 new members, the EU had bilateral or regional agreements with 111 countries. Trade agreements became an integral instrument of European foreign policy, particularly in the aftermath of the collapse of the Soviet Union.[3]

Three types of agreements were intended to stabilize the region after 1989. *Europe Agreements* were intended to prepare bordering Eastern European countries for eventual accession into the EU. They involved bilateral agreements between each other and with the EU to reduce tariffs, develop uniform rules of origin, EU-consistent regulatory approaches to services, and common treatment of standards as well as transition rules in sectors such as agriculture. These efforts culminated with the full admission of 10 new countries into the EU in 2004—which is why the number of RTAs registered with the WTO fell for the first time ever.

Euro-Mediterranean Agreements were intended to build bilateral trade relations between neighbors, with the objective of forming a NAFTA-like free trade area by 2010. Launched in 1995, the EU and 12 countries have been involved in talks on "association agreements" that would subsume some existing bilateral arrangements. To date, bilateral agreements have been signed with Tunisia (1995), Israel (1995), Morocco (1996), Jordan (1997), the Palestinian Authority (1997), Algeria (2001), Egypt (2001), and Lebanon (2002). In general, services liberalization provisions are limited to the restatement of WTO GATS commitments with no new liberalization or with preferential access reserved for suppliers based in member countries. Dispute settlement is state-to-state based on ad hoc arbitration.

Partnership and Cooperation Agreements (PCAs) with the Western Balkans, Russia, and the CIS were designed to help promote stability on the border of the EU, and in the case of Russia, expand trade. The EU has been providing technical assistance to these governments to help implement the institutional reforms that are part of the PCAs.

Two new agreements have been added to this list since 2000.

- *Economic Partnership Agreements (EPAs)* are designed to replace the preferential systems embodied in the Contonou Agreement (the successor to the Lomé Convention), which had received a waiver under the enabling clause from GATT Article XXIV, a waiver that expires in 2007. EPAs are designed to promote trade and development in the ACP 77 countries in a WTO-consistent fashion by establishing agreements between large groups of countries forming customs unions (box 2.3).
- *Free Trade Agreements* with South Africa (which entered into force in 2000), Mexico (2000), and Chile (2003) are designed to open markets and secure trade. Agreements with the Gulf Cooperation Council (GCC) and the Common Market for the South (MERCOSUR) are under active negotiation. These embody free trade provisions for a range of products as well as provisions to liberalize at least some services (Ullrich 2004).

The EU agreements govern services trade in addition to trade in goods. The agreements

Box 2.3 EPAs become the EU's trade and development instrument: An experiment in "North-South-South" integration

EPAs are the most ambitious attempt to harness trade, development resources, and technical-legal assistance to the cause of integration-led development. The objective is to promote development, strengthen regional integration, and ensure compatibility with WTO principles. By negotiating reciprocal liberalization with existing South-South regional groupings and by providing common rules of origin with cumulative provisions, participants hope to prevent the hub-and-spoke effects that plague many bilateral North-South agreements. The EPAs will also encourage liberalization of services, provide for common product standards, and set up the negotiation of investor protections, based on state-to-state ad hoc arbitration of disputes.

After a one-year clarification phase by the African Caribbean and Pacific states (ACP), the first negotiations were launched in October 2003. The EU initiated discussions with the Economic Community of West African States (ECOWAS) plus Mauritania, the Economic and Monetary Community of Central Africa (CEMAC) plus São Tomé, Eastern and Southern Africa (16 countries), the Southern African Development Community (SADC), the Caribbean ACP countries, and the Pacific states (Kiener 2004).

The content for the agreements is currently open for discussion. Reciprocal trade liberalization would be the centerpiece under the terms of the EPA program . . . (Most of the EPA countries already enjoy preferential market access that the EU grants unilaterally under this program.) In addition, the EU has stated that it would like to have services liberalization, investment, competition, government procurement, and trade facilitation covered in the agreements (Falkenberg 2004).

Several issues will determine the ultimate effectiveness of the EPAs in promoting development: the degree of additional MFN liberalization in goods and services markets in both the RTAs and in the EU; the restrictiveness of the rules of origin for goods; and the extent of trade diversion that could occur in the event that there are no concomitant reductions in MFN border protections (see Hinkle and Schiff 2004).

with Mexico and Chile provide for specific liberalization commitments in the financial sector over and above those included in GATS, with the Chilean agreement adding telecommunications and maritime services (see Ullrich 2004). The South African agreement alludes to possible services liberalization, but without commitment. The EU agreements differ in important respects from the U.S. agreements in that they are generally less comprehensive, provide less market access in agriculture, and do not provide for investor-state dispute resolution (see chapter 5).

The U.S. embraces bilateralism

Prior to the present administration, the U.S. had generally eschewed reciprocal preferential trade agreements, whether regional or bilateral. Exceptions included only Canada and Israel in the 1980s and NAFTA in the early 1990s. Indeed, many U.S. trade observers contend that opening NAFTA talks was designed primarily to support multilateral trade negotiations—to spur the Europeans and others into acting on the Uruguay Round. Two years later, the Clinton administration announced its desire to form a Free Trade Area of the Americas (FTAA), and it signed an FTA with Jordan in 2000.

Since the approval of trade promotion authority in 2002, however, the United States has given much greater emphasis to securing bilateral FTAs in tandem with its efforts to achieve multilateral liberalization through the WTO. Since 2002 the United States has signed bilateral accords with Australia, Bahrain, Central America plus the Dominican Republic, Chile, Morocco, and Singapore. The United States appears to have intensified its pursuit of RTAs since the Cancun WTO Ministerial (September 2003). Negotiations are officially[4] under way with Colombia, Ecuador, Panama, Peru, SACU, and Thailand. Other economies deemed to be in the queue are Bolivia, Egypt, New Zealand, Pakistan, the Philippines, South Korea, Sri Lanka, and Taiwan (China), and Uruguay (Schott 2004). This intensified pace may reflect the intention to prod both the multilateral negotiations and the FTAA, as well as to respond to U.S. businesses that fear being shut out of export markets by a growing number of RTAs in which the United States is not a member.

In the broadest of terms, developing countries seek to provide access to their services markets and guarantees in many nontrade areas in exchange for assured access to U.S. goods markets. Key facets of these agreements include:[5]

- Tariff rates on most nonagricultural products are bound at zero; for example, the U.S.-Chile FTA will bind duties at zero for 85 percent of trade.
- Exclusion or delayed liberalization of sensitive products, commonly including agricultural products such as dairy products, cotton, ethyl alcohol, peanuts and peanut butter, sugar, and tobacco for the United States. Some exclusions are due to be phased out according to lengthy timetables; in the Chile-U.S. FTA, for example, all duties will be phased out in 12 years (USTR 2004).
- Intellectual property rights are conventionally accorded stronger protections than under the WTO's TRIPS agreement, with investor-state suits permitted in the event of disputes.
- Investment protections, with provisions for national treatment and nondiscrimination in pre-establishment provisions for companies based in each others markets (though liberal rules of origin indicate foreign subsidiaries located in member countries qualify for eligibility).
- Services trade are to be open except for those excluded in a negative list; notably excluded are labor service providers, except for the provisional visas held by professionals associated with investing firms.
- Labor and environment issues are included in recent agreements, with signatory countries undertaking commitments to enforce their own environmental and labor laws. Dispute settlement panels are empowered to impose monetary fines rather than using trade sanctions to force compliance (box 2.4.)

Box 2.4 Labor in U.S. FTAs

Until NAFTA, the United States did not attempt to include provisions on labor in trade agreements that it negotiated. As a presidential candidate, Bill Clinton promised to negotiate new side agreements to NAFTA on labor in order to secure sufficient political support for NAFTA. Since then labor issues have featured prominently in Congressional debates on granting the president negotiating authority and the resulting trade agreements.

All recent FTAs negotiated with the United States contain provisions requiring parties to enforce their own labor laws. These are premised on the assumption that each member's existing laws are satisfactory and therefore any trade distortions that might arise are caused by a lack of enforcement. The agreements enumerate five core standards: the right of association; the right to organize and bargain collectively; prohibitions on forced labor; a minimum age for employment of children; and acceptable working conditions. The FTAs establish a procedure for making complaints, encouraging resolution first through consultation and, if this fails, by establishing a panel of experts to hear the dispute.

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Box 2.4 *(continued)*

The labor provisions break new ground in how a dispute settlement panel's decisions are enforced. Rather than using trade remedies (i.e., granting the injured party the right to withhold trade concessions), a panel can impose a monetary fine of up to $15 million per year (adjusted for inflation). Payments of the fines would go into a fund to support appropriate labor initiatives, which may include efforts to improve enforcement of labor laws. This mechanism appears in the agreements that the United States has signed with Australia, Bahrain, Chile, Central America and Dominican Republic, Morocco, and Singapore.

Using fines rather than trade sanctions has several advantages: while trade sanctions penalize both polluting and clean exporters, fines target the polluters; increased trade sanctions hurt all workers in export industries, but fines help restructure plants and maintain employment; and fines build in targeted solutions to the problem rather than present protracted trade disputes.

Sources: Destler and Balint 1999, texts of FTAs on the USTR web site (www.ustr.gov), and Weintraub 2004.

The United States indicated it would not negotiate changes in its antidumping statutes or on its agricultural subsidies, insisting on addressing both through the WTO's multilateral negotiations. In chapter 5, we return to a deeper discussion of provision for services, investment, and intellectual property rights (IPR).

Developing countries actively pursue major markets

The launching of NAFTA spawned a new flurry of interest among developing countries eager to use RTAs to secure market access. Mexico and Chile have been at the forefront of these developments. Mexico, having created a world-class trade negotiating team for NAFTA, turned its attention to Central America and other countries in Latin America. It established arrangements with Costa Rica (1995), Bolivia (1995), Nicaragua (1998), the EU (2000), EFTA (2001), and Japan (2004). After NAFTA was signed, Chile immediately solicited entry into the accord. Rebuffed initially, the country embarked on a wider strategy. Chile established agreements with MERCOSUR (1996), Canada (1997), Peru (1998), Mexico (1999), Central America (2002), the United States and EU (2003), and EFTA (2004). By 2004, Chile had signed free trade agreements that provided over 60 percent of its exports with duty-free access to markets around the world (see Devlin and Estevadeordal 2004).

Many existing regional organizations in Africa also moved aggressively to intensify preferential trade liberalization during the 1990s. For example, the treaty establishing the Common Market for Eastern and Southern Africa (COMESA), which was signed in 1993 to replace the Preferential Trade Area, called for a free trade area by 2000 and a customs union by 2004. The East African Community was formed in the mid-1990s to accelerate economic integration among three COMESA members (Kenya, Tanzania, and Uganda). The SADC Trade Cooperation Protocol was signed in 1996 as part of an effort to reintegrate South Africa into the regional economy after the end of apartheid.

Asian countries have launched similar negotiations since 2001. India has concluded or is negotiating limited arrangements with MERCOSUR and Thailand; MERCOSUR is negotiating with the Andean countries; China has launched bilateral accords with members of the Association of Southeast Asian Nations (ASEAN), to mention a few. In 2004, India, Pakistan, and other South Asian countries announced the South Asian Free Trade Agreement

Table 2.2 RTAs cover many topics besides merchandise trade

	Standards	Transport	Customs Cooperation	Services	Intellectual Property	Investment	Dispute Settlement	Labor	Competition
U.S.									
U.S.-Jordan	No	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
U.S.-Chile	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
U.S.-Singapore	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
U.S.-Australia	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
U.S.-CAFTA	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	No
U.S.-Morocco	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	No
NAFTA	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
EU†									
EU-South Africa	No	No	No	No	Yes	No	Yes	No	Yes
EU-Mexico	Yes*	Yes	Yes*	Yes	Yes	Yes	Yes	No	Yes
EU-Chile	Yes*	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes
Euro-Med. Agreements	No	No	No	No	Yes	No	Yes	No	Yes*
South-South									
MERCOSUR	Yes	Yes	Yes	Yes	No	Yes	Yes		Yes
Andean Community	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes
CARICOM	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes
AFTA	Yes	Yes	Yes	Yes	No	Yes	No	No	No
SADC		Yes	Yes		Yes	No	Yes		
COMESA	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes
Other									
Japan-Singapore	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Canada-Chile	No	No	Yes	Yes	No	Yes	Yes	Yes	Yes
Chile-Mexico	Yes		Yes	Yes	Yes	Yes	Yes	Yes	Yes

Source: World Bank staff.
†While EU agreements mention cooperation in most of the subject areas, only those in which specific commitments are undertaken receive a "Yes" rating.
*Implementation steps are to be agreed on at a later date.

(SAFTA), which is intended to encompass all of the countries of the region (see Baysan 2004; Newfarmer 2004).

Many RTAs, diverse provisions

RTAs have increasingly been designed to cover much more than liberalization of tariffs and quotas. New provisions on enforcement of domestic labor and environmental laws have already been mentioned. Table 2.2 gives a flavor of the range of services and intellectual property rights issues that are addressed in current agreements. Many of these issues, which are dealt with in more detail in later chapters, have implications for trade, although the precise mechanisms by which trade is affected are not always well defined.

Many RTAs, many rationales

These recent trends highlight different rationales that drive the quest for preferential agreements, but in nearly all cases politics is as important as economics. The classic *North-North* agreement, the European Union, had its origin in politics (see Schiff and Winters 2003). The fathers of the European Community, Robert Schumann and Jean Monnet, clearly believed that Franco-German integration through trade and investment would produce a new constellation of common economic interests that would attenuate historic military animosity. As a first step, they felt that placing French and German coal and steel industries under a single authority, the European Coal and Steel Community, would make it impossible for either of these historical enemies to use these resources for military purposes against the other.

Today, for *North-South* agreements, Northern partners often have a complex mix of rationales—rooted in foreign policy, commercial diplomacy, and development policy.

"Trade policy has always been the principal instrument of foreign policy for the European Union" (Sapir 1998). The United States now appears to be using preferential agreements for reasons that are similarly broad. Both the EU and the United States seek trade agreements that go beyond simple tariff removal to include rules governing services, protection of intellectual property, and adherence to health, labor, and environmental standards.

One goal of developing countries seeking an RTA with a large market, such as the EU[6] or the United States, is simply to secure market access. One should note, however, that most developing countries, especially the least developed countries (LDCs), already enjoy considerable access to these markets for most manufactured products (whether through unilateral preference programs or because MFN tariffs are already quite low), and RTAs with these countries often exclude agriculture and other politically sensitive products. Nevertheless, RTAs provide some insurance against future protectionist policies, and by reaching an agreement "preemptively," they seek to avoid being left out of a future agreement.

A second objective is to reinforce internal regulatory reforms through external treaty obligations and visible political commitments. Locking in domestic reforms through a foreign trade agreement with the EU clearly motivated countries making the transition from socialism in the 1990s. Mexico under NAFTA was motivated by a similar objective. Guaranteed market access combined with credible domestic reforms can attract foreign direct investment (see chapter 5).

South-South agreements often reflect a political desire to form or join a broadly based regional initiative, such as ASEAN, COMESA, or MERCOSUR. The drive for economic integration often begins with political objectives. Like France and Germany in the 1950s, the newly established democracies of the Southern Cone formed MERCOSUR in the mid-1980s in the hopes of damping the traditional military hostility between major regional powers—Argentina and Brazil. SADC originated in the 1980s as a coalition opposed to apartheid in South Africa and has more recently turned to creating a free trade area. Some observers note that African customs unions and free trade areas are as active in areas such as conflict resolution as in trade liberalization. Finally, many see relaxed tensions between India and Pakistan as the real payoff from the proposed SAFTA agreement, regardless of what happens to trade barriers in the region. The tentative conclusion of existing studies is that RTAs that expand trade flows appear to have a substantial dampening impact on conflict (box 2.6).

Box 2.5 Trade agreements and the environment

It is important to establish coherent relationships between environmental policies and the trade obligations set out in various RTAs. The following examples illustrate the various ways that environmental issues are handled in these trade agreements.

WTO. Within the WTO, environmental provisions are limited to the adoption of product-related measures as "necessary to protect human, animal or plant life or health," or "relating to the conservation of exhaustible natural resources." Process-related requirements continue to remain outside the scope of the WTO. However, in the absence of agreed-on international standards (e.g., fisheries), the risk of disguised protectionism has prevented further consensus on the way forward. Long-standing disputes between the United States and other countries on tuna fishing and dolphin or turtle protection are cases in point.

NAFTA. The environmental agreement under NAFTA created the Commission for Environmental Cooperation to promote environmental cooperation among the three members. The commission itself does

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Box 2.5 *(continued)*

not set standards in the various countries, though part of its mandate is to help harmonize them upward. If a country persistently fails to enforce environmental laws that have conferred a trade benefit, dispute settlement provisions can be invoked. The commission's role in the disputes is to see that enforcement of existing laws takes place. In addition, it is charged with monitoring the environmental effects of NAFTA. Articles of agreement also dictate that countries will not try to attract investment by relaxing or ignoring domestic health, safety, or environmental regulations. International environmental agreements recognized by the three parties take precedence over national rules.

MERCOSUR. Environmental concerns are currently being dealt with in MERCOSUR by a working group. This group has discussed issues such as the environment, competitiveness, non-tariff barriers to trade, and common systems of environmental information. A draft agreement from this working group provides for upward harmonization of environmental management systems and increased cooperation on shared ecosystems, in addition to mechanisms for social participation. It also includes provisions on instruments for environmental management, including quality standards, environmental impact assessment methods, environmental monitoring and costing, environmental information systems and certification processes, provisions for protecting health and quality of life, and other general mechanisms for implementing the protocol. The regime is still evolving, and the challenge at hand is to ensure that the promise of the protocol leads to effective regional cooperation and action.

Bilateral agreements. A number of recently concluded bilateral FTAs, including the U.S.–Singapore FTA and the Japan–Singapore Economic Agreement for a New Age Partnership, contain environmental provisions. The U.S.–Singapore FTA establishes an important precedent for dealing with environmental issues by including a chapter specifically on the environment. As discussed in box 2.4 on labor laws, this agreement ensures that countries effectively enforce their environmental laws, and it provides for enforcement mechanisms, including fines.

Even in the absence of such special provisions, however, trade agreements can contribute to a cleaner environment simply by making trade more responsive to market forces. In general, countries that are more open to trade adopt cleaner technologies more quickly, and increases in real income are often associated with greater demand for environmental quality (WTO 1999). Opening up domestic markets also encourages cleaner manufacturing, because protectionist countries tend to shelter pollution-intensive heavy industries. The incentives to over-exploit or deplete resources are more directly related to policies and institutions within the sector than to trade openness per se (World Bank 1999).

Not all political objectives involve war and peace issues; some *South-South* agreements are designed to pool resources for trade negotiations and trade policymaking. Much as the European Union established a common trade policy with a common commissioner in charge of trade (in part to negotiate more forcefully with the United States in the GATT), so too a driving force for MERCOSUR was to establish a common trade policy relative to the multilateral and hemispheric system.

Entering into a regional agreement may also reflect a desire to deal with region-specific issues—such as transit, water, energy, migration, movement of labor, customs, and standards—that are difficult to broach at the global level. RTAs among CIS countries are arguably an attempt to reconstruct some of the economic linkages that were severed with the disintegration of the Soviet Union and the disorganization caused by the collapse of central planning. Although many of these regional externalities can be handled without a *trade* agreement, RTAs may provide institutions and a framework through which to make progress on these issues (see chapter 4).

The wide variation in RTAs flows from the very different motivations countries have for

Box 2.6 Can RTAs prevent conflict?

Does trade inhibit or increase hostilities between states? Greater contact among traders and consumers across borders may stimulate mutual respect and more harmonious relations, and high levels of trade can create economic interdependence, which, in turn, raises the cost of political disputes and military conflict.

In 1889, Wilfred Pareto suggested that "customs unions and other systems of closer commercial relations [could serve] as means to the improvement of political relations and the maintenance of peace." In 1919, John Maynard Keynes wrote that "a Free Trade Union, comprising the whole of Central, Eastern and South-Eastern Europe, Siberia, Turkey, and (I should hope) the United Kingdom, Egypt and India, might do as much for the peace and prosperity of the world as the League of Nations itself."

RTAs also can provide institutions and a forum for bargaining and negotiation—to address tensions before they erupt in conflict. European integration, ASEAN, and MERCOSUR are often cited as venues for improving political-military relations. Regional trade agreements do not ensure positive political outcomes, however. The U.S. civil war (1861–65) was fought—at least in part—over high protection of northern manufactures and trade restrictions on cotton. Similarly, the Central American soccer war of 1969 emerged out of lingering hostility over trade arrangements that created advantages for El Salvador at the expense of Honduras. And one reason Bangladesh seceded from Pakistan was the common external tariff structure that deprived it of access to cheaper inputs from the global market and diverted trade to Pakistan (Schiff and Winters 2003).

Mansfield and Pevehouse (2000) attempt to identify empirically the role of RTAs in ameliorating conflict. They find that, on average, the likelihood that a pair of states will see the outbreak of a militarized interstate dispute declines by around 50 percent if both belong to the same RTA. However, only RTAs that expand trade flows appear to have a substantial impact on conflict. When evaluated at the lowest level of trade between partners, it appears that membership in a RTA reduces the chance of dispute by just 15 percent. Other studies have suggested that RTAs that have little impact on trade may actually exacerbate conflict (see Powers 2003). If the gains from trade are not distributed evenly, for example, then the subsequent change in interstate power relations can be a source of increased tension. Also, rising interdependence may be seen as a source of increasing vulnerability, making expansion through military force appear more attractive.

These results, which suggest that RTAs could contribute to a reduced risk of military conflict, should be treated with a high degree of caution, due to problems of causality and omitted factors, such as the broader institutional framework governing relations between particular pairs of countries. In Africa, for example, RTAs that address the management of cross-border resource issues (such as water) are more effective in reducing military conflict than other RTAs.

entering into the arrangements. As we will see in subsequent sections, these motivations contribute to greater complexity in rules governing world trade.

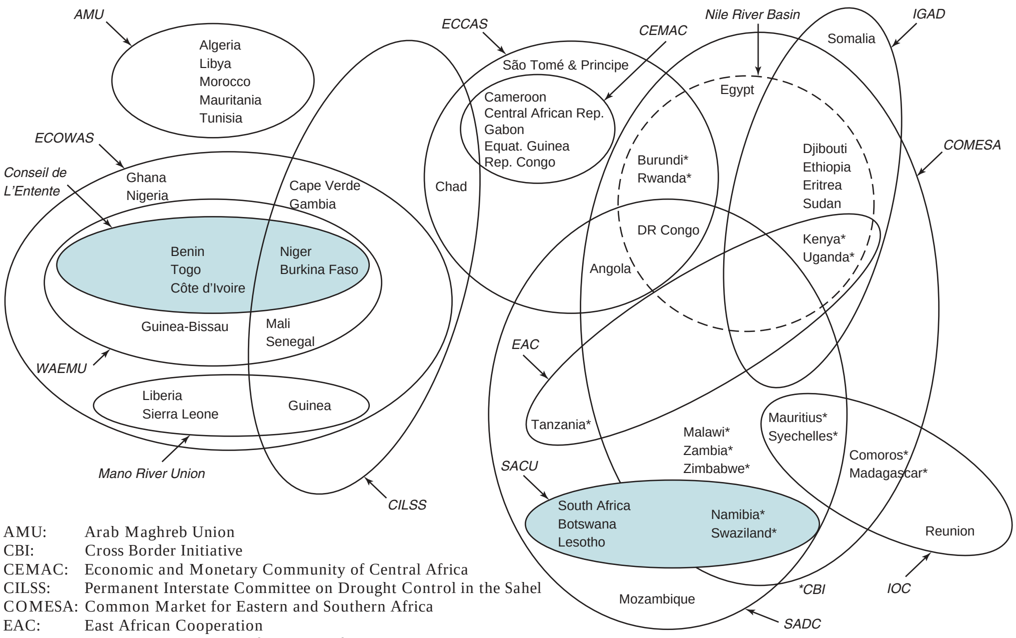
Many RTAs can complicate administrative procedures

An important feature of the rise in the number of RTAs is the growing number of overlapping agreements and the so-called "spaghetti bowl" that has emerged from the proliferation of bilateral agreements (figure 2.2). The associated myriad of rules strains institutions charged with administering trade agreements. A web of differing trade arrangements can tangle administrative procedures—customs procedures, technical standards, rules of origin, and so on—and thereby raises the costs for both enterprises and governments. This complexity undermines work toward greater trade facilitation in developing countries.

Many agreements between country pairs are duplicated by other agreements to which the same two countries are parties. In Sub-Saharan Africa, for example, about one-half of

Figure 2.2 Spaghetti and rigatoni: Multiple, overlapping RTAs, 2004

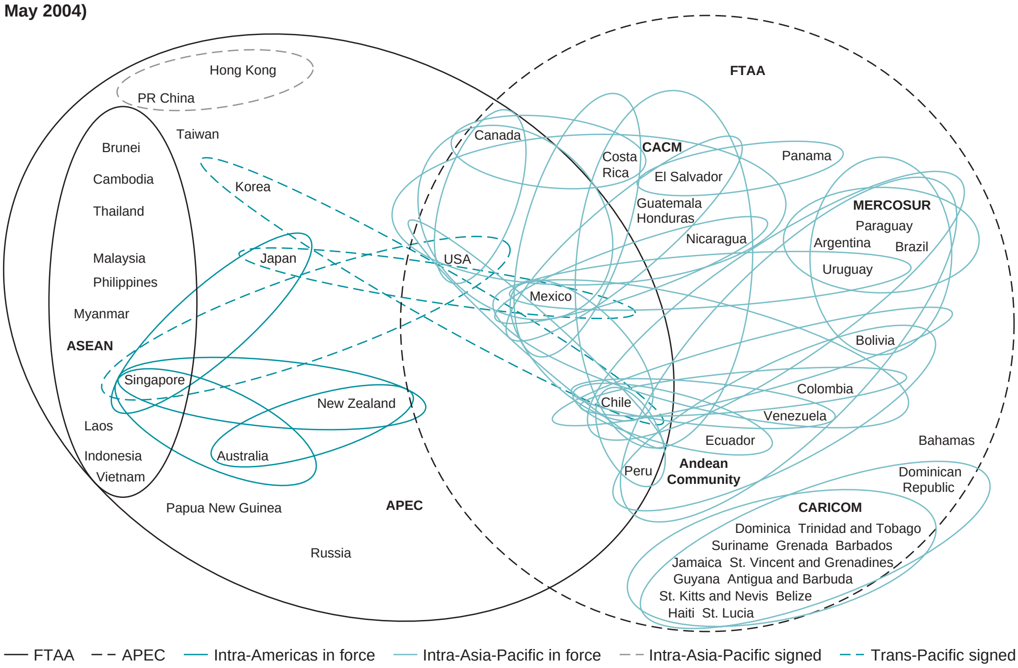
a. African agreements are overlapping



AMU: Arab Maghreb Union
CBI: Cross Border Initiative
CEMAC: Economic and Monetary Community of Central Africa
CILSS: Permanent Interstate Committee on Drought Control in the Sahel
COMESA: Common Market for Eastern and Southern Africa
EAC: East African Cooperation
ECOWAS: Economic Community of Western African Studies
IGAD: Inter-Governmental Authority for Government
IOC: Indian Ocean Commission
SACU: Southern African Customs Union
SADC: Southern African Development Community
WAEMU: West African Economic and Monetary Union
* Indicates membership in CBI regional grouping

Source: Schiff and Winters 2003.

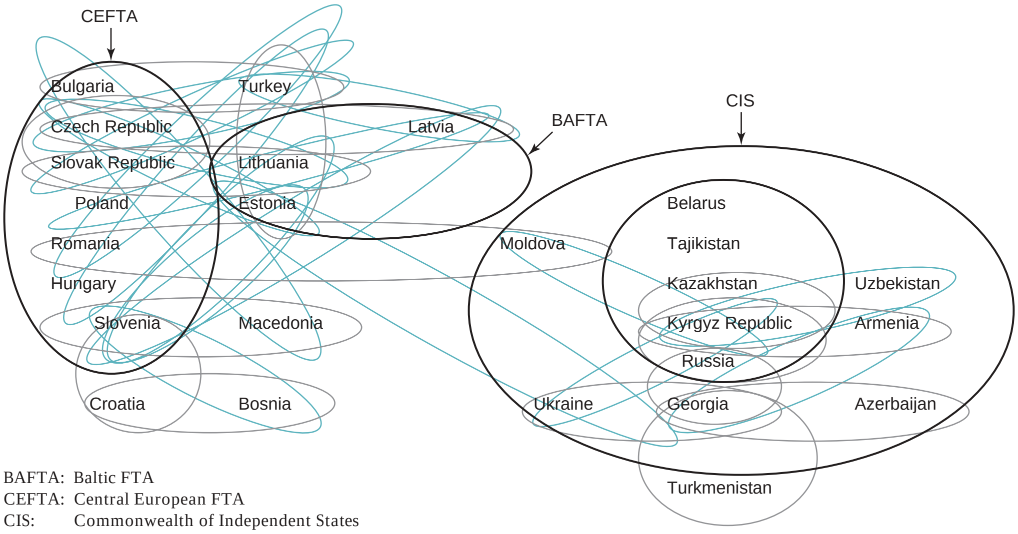
b. "Spaghetti Bowl" of RTAs in the Americas and Asia-Pacific (Agreements signed and in force in Latin America as of May 2004)



Source: Devlin and Estevadeordal 2004.

Figure 2.2 (continued)

c. In Eastern Europe and Central Asia, bilateral agreements burden customs officials*



BAFTA: Baltic FTA
CEFTA: Central European FTA
CIS: Commonwealth of Independent States
* Prior to EU expansion.

Source: World Bank staff.

the pairwise trade relationships covered by an RTA are also covered by another agreement. In other regions, overlapping agreements also comprise a substantial share of the total number of agreements. There would be significant benefits, in terms of lower administrative costs and more effective implementation, from a rationalization of the current structure of overlapping agreements.

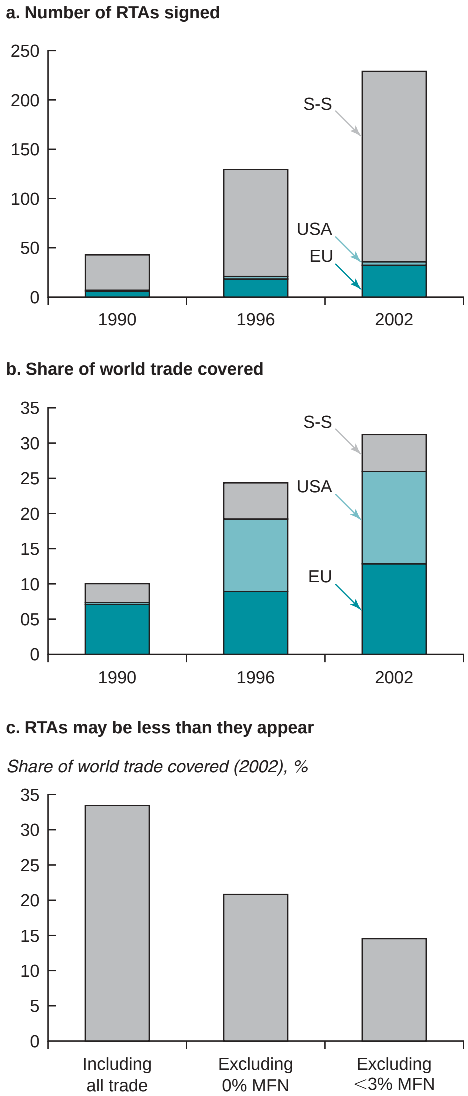
Uneven terms—hub-and-spoke integration

The substantial number of bilateral agreements involving large northern countries, most of which have been signed since 1990, suggests that a hub-and-spoke structure in world trade is emerging. Of the 109 North-South bilateral agreements, 86 have been created since 1990. In a hub-and-spoke trading system, the largest markets sign individual agreements with a wide range of peripheral countries among which market access remains restricted. Such agreements can marginalize the spokes, where market access conditions are usually less advantageous than in the hub, which enjoys improved access to all of the spokes. In comparison with a broad preferential trade agreement, a hub-and-spoke approach in theory generates lower gains, which accrue mainly to the hub (Wonnacott 1996). Hubs and spokes are already clearly discernible as the EU and United States extend restrictive rules of origin from one bilateral agreement to another.[7]

Trade within RTAs is rising but preferential trade is less important

Trade between RTA members is growing as the number of agreements increases, and one-third of world trade now takes place between RTA members (figure 2.3). (Here we cover only reciprocal agreements and exclude trade under the Generalized System of Preferences, Cotonou Agreement, and AGOA.) Disregarding intra-EU trade, bilateral flows between RTA members have been growing at a rate similar to the growth rate of agreements themselves, as shown in figure 2.3. This figure

Figure 2.3 Trade within RTAs



Note : EUN is EU-15.
Source: World Bank staff.

also reveals that the rapid increase in the number of South-South RTAs signed in the past decade has not been matched by much change in trade flows among parties to these agreements. This discrepancy highlights a point made earlier: many new South-South agreements overlap with existing agreements.

Examining total trade flows between RTA partners overstates the amount of trade that takes place on a preferential basis. However, tariff schedules of many RTA members increasingly contain duty-free MFN rates on which no preference can be given. We estimate that the amount of preferential trade among RTA members, after accounting for MFN rates of zero, is much lower at 21 percent of world trade (figure 2.3). Furthermore, it is often more profitable for enterprises to pay a low MFN tariff when there are high costs to satisfy rules of origin or other administrative procedures that a trader must follow to qualify for preferential treatment under an RTA. If we exclude trade covered by facing tariffs of 3 percent or less, we conclude that, at present, the amount of global trade taking place under an economically meaningful tariff preference is around 15 percent. An earlier estimate on a similar, but not directly comparable, basis suggests that in the mid-1990s, trade on a preferential basis amounted to 27 percent of global trade.[8]

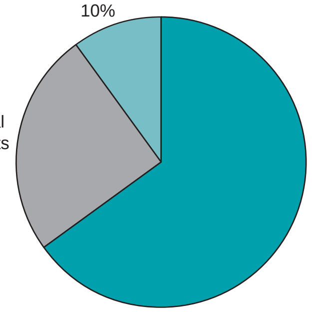
While the number of RTAs has been increasing, the importance of preferential trade has been falling, reflecting lower tariff barriers, especially in OECD countries. Since 1996 the number of zero duty lines in the EU tariff schedule has increased from 13 to 21 percent of the total number of tariff lines and from 18 to 32 percent for the United States. In 2002 about 45 percent of the tariff lines in the EU and United States schedules had duties of 3 percent or less. This reflects the impact of multilateral liberalization under the Uruguay and earlier trade rounds. Thus a large and growing proportion of EU and U.S. imports from preferential trade partners is unlikely to actually receive preferential access relative to other countries.

For many developing country agreements, the situation is different because the number of low-duty tariff lines is small. In 2002, 6 percent of Brazilian tariff lines had MFN tariff rates of zero, as did 1 percent of Indian tariff lines. We estimate that 88 percent of trade between

Box 2.7 Regional versus multilateral and unilateral liberalization: What's more important?

How does liberalization in RTAs compare to autonomous and multilateral liberalization? The rapid expansion of RTAs has occurred during a period when developing countries were undertaking autonomous liberalization and also fulfilling commitments made during the Uruguay Round of the GATT. An examination of tariff reductions by developing countries finds that neither RTAs nor multilateral negotiations represent the largest driver of liberalization. Autonomous liberalization accounts for the lion's share of trade liberalization since the 1980s. The trade-weighted average MFN tariff rate levied by the 33 largest developing country importers (which collectively account for 90 percent of all developing country imports) was 29.9 percent in the 1980s. By 2003 the average MFN rate had dropped to 11.3 percent. Based on tariff concessions granted during the Uruguay Round, multilateral negotiations account for 5.1 percentage points of the total decline in MFN tariffs, and the remaining 13.5 percentage points resulted from autonomous liberalization. If the RTAs that these 33 countries have signed were fully implemented, the trade-weighted average applied tariff would fall further to 9.3 percent. The chart below shows how trade liberalization is allocated according to these different sources.

Share of total tariff reduction, by type of liberalization, 1983–2003



Source: Martin and Ng 2004.

countries in Latin America is potentially eligible for preferential treatment under an RTA.[9] For the Middle East and North African countries it is 83 percent of the total. The new SAFTA will lead to three-quarters of the trade between members taking place on a preferential basis (assuming all products are included). East Asia is an exception, where, for example, 22 percent of Indonesian and 59 percent of Malaysian tariffs are zero. Thus the amount of trade between East Asian countries receiving tariff preferences is very small. Like OECD countries, however, developing countries have taken great strides to reduce MFN tariffs during the past two decades. Most of this liberalization has come from autonomous reductions and not through trade agreements—either RTAs or multilateral trade negotiations (see box 2.7).

Trends in Trade and Growth by Region

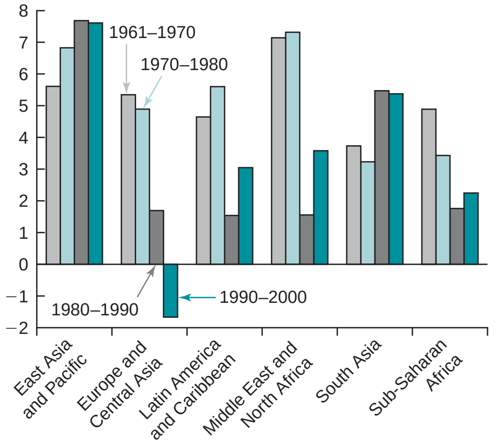
These agreements were superimposed in a context of deep changes in global trading patterns.[10] The postwar period has seen major global shocks and changes in the economic environment, including oil crises in the 1970s and financial crises in the 1980s and 1990s. In the past 20 years there have also been major changes in policy regimes. Socialist countries across the world restructured their economic systems and started the process of reorienting their trade to the world economy. In the former Soviet Union, this meant collapse and reconstruction; in East Asia it meant progressive, sustained, and profound institutional change. Latin America went through its own, if less dramatic, transition from import-substitution industrialization to a strategy of outward-oriented growth. Apartheid in South Africa, political strife in various parts of the continent, and the struggle against HIV/AIDS delayed the establishment of stable policies and depressed growth throughout Africa. It has been a period of major transitions.

The growth performance of developing countries in the past 20 years reflects this varied experience (figure 2.4). Only the East

Figure 2.4 Trade performance has differed across regions

a. East Asia and South Asia grew rapidly in 1980–2000, but other regions slowed

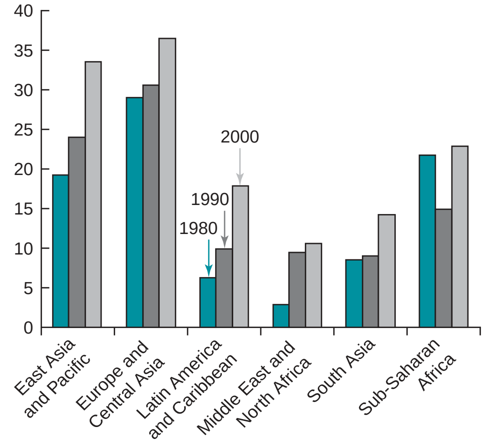
GDP growth rates by region (percent)



Source: World Bank staff.

b. Exports became the driving force of growth everywhere

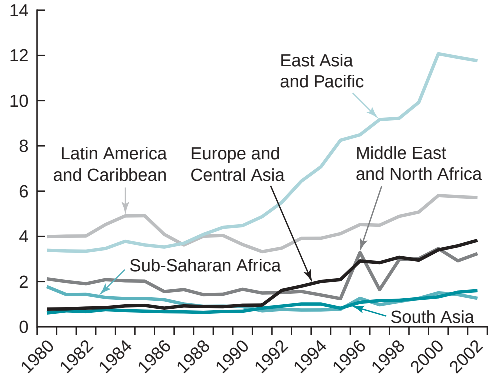
Non-oil export share of GDP (percent)



Source: World Bank staff using WITS for non-oil/total exports ratio.

c. East Asian exports grew fastest, and all but South Asia and Africa increased their share of the global market

Regional exports as share of world exports (percent)(oil excluded)

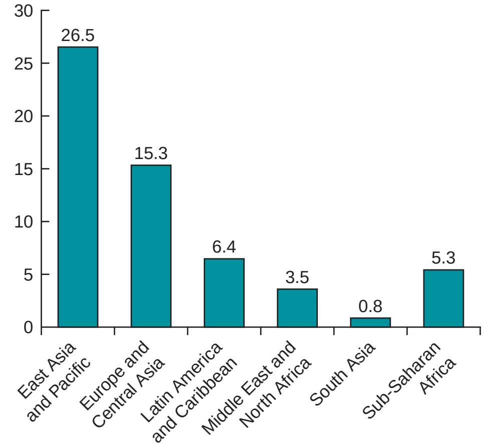


Note: Data obtained from GTAP release 5.4 up to 1998, the following years are projected from 1998 using regional growth rates calculated from COMTRADE.

Sources: GTAP 5.4 and COMTRADE.

d. Integration with the world proceeded hand in hand with regional integration

Intra-regional trade as a share of GDP (percent), 2002

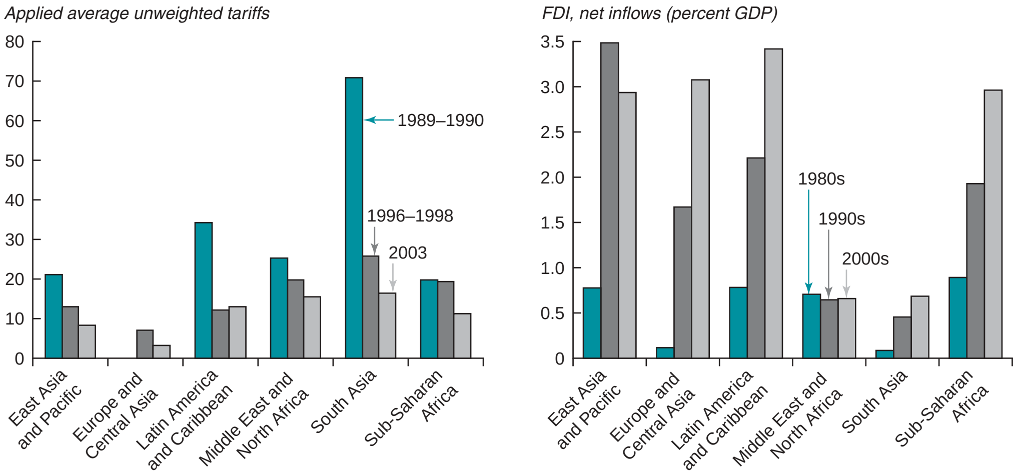


Source: COMTRADE.

Figure 2.4 (continued)

e. One reason: East Asia liberalized early in trade

f. Strong FDI flows coincided with relocation of production processes



Source: TRAINS.

Note: Period averages for 1980–1989, 1990–1999, and 2000–2002 calculated from annual data. For all regions except LAC, some observations are missing.

Sources: World Bank, WDI.

Asia and Pacific and South Asia regions experienced higher GDP growth rates in the 1980–2000 period than during 1960–1980. The other four regions fared worse in the last two decades, with GDP growth rates that were one-half to two-thirds smaller than between 1960 and 1980.

Nonetheless, trade grew. The share of trade in GDP grew in all regions in the 1990s. East Asian exports grew faster than the other regions, and the region increased its share of total world exports throughout the 1980s and 1990s. Latin American exports also grew consistently as a share of the world market during the 1990s, but not as steeply as for East Asia. In South Asia, however, although GDP growth increased in the 1980–2000 period and the export share of GDP rose in the latter part of that period, the trade growth is from a much smaller base. South Asia still has the lowest trade shares of any region. Sub-Saharan Africa has also had disappointing growth performance. These trends reflect different initial conditions and external shocks, changes in development strategies, and policies toward trade liberalization.

East Asia generally followed a strategy of export-led growth, through elimination of anti-export bias and sustained nondiscriminatory (MFN) liberalization. This trend was most dramatic in China, where border barriers at the start of the decade were prohibitive for most tariff lines, and by the end of the decade averaged less than 12 percent, with a plan to go to less than 10 percent by 2004. But virtually all countries were liberalizing. Average tariffs for the region as a whole fell from about 23 percent in 1989–90 to 8 percent in 2003.

In Europe and Central Asia the disintegration of the Soviet Union after 1990 caused the collapse of growth and required profound restructuring of the region's economies and a redirection of its trade. Roughly half of the region was drawn to the magnet of the EU's large and stable market. The EU responded with technical assistance and a political willingness to admit its Eastern European neighbors as full members. The combination of a political framework, trade, investment, and technical assistance led to an unprecedented pace of reforms and economic integration that culminated with 10 states joining the EU on May 1, 2004. With their eyes turned toward markets in the EU, the Central European and Baltic countries achieved more extensive integration and higher trade and FDI flows, which is evident in the rapid export growth of the region as a whole.

The CIS has moved much more slowly in its process of reform and reorientation, particularly in Central Asia and the Caucasus. Under the CIS-7 initiative, trade regimes have been generally liberalized, but have been limited by regional trade and transit barriers.

Latin America reversed its trade policy stance, and during the 1990s average tariffs in the region declined from over 30 percent to 12 percent. The region's share of the world markets increased and net inflows of foreign direct investment (FDI) as a percent of GDP steadily climbed, reaching 5 percent of GDP in 1999—higher than East Asia. Overall, FDI net inflows in the latter half of the decade more than doubled from an average of 1.4 percent of GDP in the first half to an average of 3.6 percent in the second half.

In the Middle East, policy and economic barriers, together with a reliance on oil for several countries, prevented rapid growth in trade. High tariff rates, restrictions on services entry, and controls on agriculture interacted with poor investment climates to impede trade and keep transactions costs high. A large state-led sector also shaped a noncompetitive industrial policy that discouraged trade. Average tariff rates were almost 30 percent in the late 1990s, mirroring the import substitution policies early in Latin America and more recently in India. Flows of foreign direct investment as a percent of GDP have recovered in the last decade, but still remain quite low at less than one percent.

South Asian countries other than Sri Lanka neither liberalized trade rules nor the rules governing inflows of foreign direct investment until the 1990s. Removal of the most egregious forms of anti-export bias and gradual domestic reforms, together with textile preferences, produced a rapid expansion in garment/textile exports, and led to high growth rates for exports in the 1990–2000 period and an increasing share of exports in GDP. Since growth was from a low base, South Asian exports as a share of world trade have remained low throughout the 1980–2000 period. South Asia maintained the highest levels of average applied tariffs, even compared to the import-substitution industrialization period of other regions. However, this is changing. Nepal launched trade liberalization in the early 1990s. Sri Lanka and then Pakistan in 1997 began to reduce their border barriers and increase their trade with the world economy. India began to reduce border protection from very high levels in the early 1990s and has continued doing so; in early 2004, India announced tariff cuts of roughly one-third, reducing the average tariff rate to about 22 percent. Bangladeshi border protections are still among the highest in the world, but they too announced reductions in 2004.[11] The region remains only minimally integrated in world capital markets. Net inflows of FDI, although higher than in the early 1980s, are less than 0.8 percent of GDP—the lowest of all the regions.

As with the Middle East and North Africa and South Asia regions, Sub-Saharan Africa remains weakly integrated into the global market. Although exports as a share of GDP in Sub-Saharan Africa increased in 2000, exports as a share of world exports have remained flat throughout the last decade and are lower than in the early 1980s. GDP growth has also been worse than in the earlier decades. Many countries in Sub-Saharan Africa are dependent on only a handful of commodities with highly volatile prices; most face very high transport costs and have weak institutions to facilitate trade. These countries have also experienced a number of armed conflicts throughout the previous decades and are plagued by endemic diseases such as malaria and HIV/AIDS, which have major impacts on their economies and societies. All these factors hobble trade performance.

Changing Export Composition and the Rise of Global Production Networks

The differential in trade and growth performance reflects the fact that certain regions have been better placed—in part through the policies they adopted—to take advantage of new technologies and changes in the nature of world trade. Not only has the volume of international trade expanded in the postwar period, but also its structure has changed in three fundamental ways. First, exports of manufactured products from developing countries, and trade in manufactures among them, have become increasingly important for all regions. Second, trade integration has allowed developing countries to specialize (most evident in the emergence of production chains), with trade in intermediates becoming more important. This trend is also evident in the role that new products play in production. Finally, foreign direct investment is playing an ever-increasing role in the integration process. These developments have facilitated the integration of countries that have adopted relatively open trade policies, and have increased the disadvantages facing countries that have segmented themselves from global markets.

Specialization in manufactures

Manufactured products as a share of exports increased strongly between 1981 and 2001 for all regions (figure 2.5). Countries in East Asia and later, Latin America and Eastern and Central Europe, have followed open development strategies that have led to increasing exports, especially of manufactures. The share of manufacturing in exports from East Asia, for example, increased from about 52 percent in 1981 to 88 percent in 2001, while the share in Latin America tripled from about 20 percent to 60 percent.

Trade has allowed manufacturers to exploit economies of scale, specialization, and scope. This is reflected in the growing share of parts and components in total exports. In the three more open regions—East Asia and Pacific, Europe and Central Asia, and Latin America and the Caribbean—parts and components trade has surged. This international segmentation of production—"production chains" in which intermediate inputs are traded and transformed into more processed intermediate inputs, which are then moved across borders to the next stage in production—has been a major factor driving the surges in intra-regional trade in those areas.

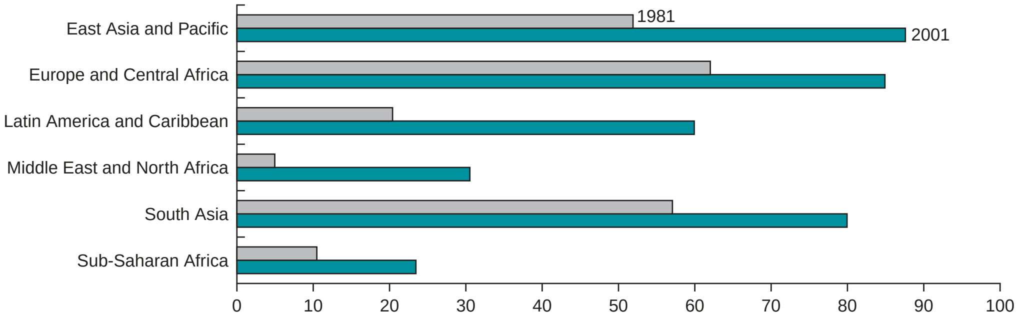
One indicator of specialization is the import content of exports. To measure the role of imported intermediates in trade, we calculated an index of vertical specialization, which measures the share of the value added of an export accounted for by imported intermediate inputs, either directly as imported inputs in the exporting sector or indirectly through the use of imported inputs in the domestic production of intermediate goods used by the exporting sector.[12] Vertical specialization is most important in East Asia, and least important in South Asia and Sub-Saharan Africa (figure 2.5c).

The evolution of production chains and finer division of the production processes across countries, including developing countries, allows producers to exploit potential efficiency gains from: (1) local increasing returns to scale in the production of intermediate inputs, (2) regional differences in factor costs for different parts of the production process, (3) increased competition from a wider market, and (4) technology transfer

Figure 2.5 Composition of trade has changed

a. Manufactures have become increasingly important

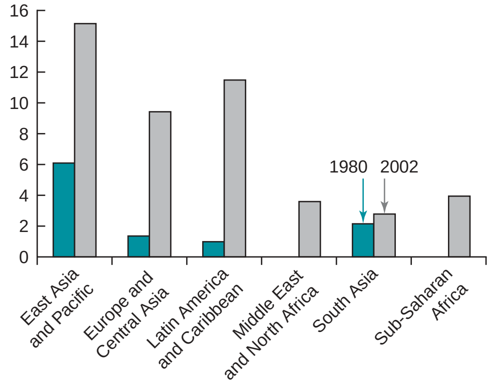
Manufactures: Share of exports by region, %



Source: UN COMTRADE.

b. Parts and components have increased for all regions

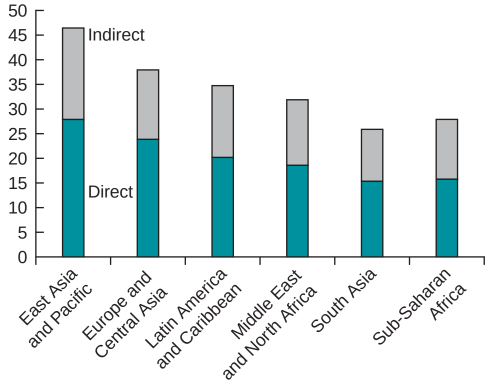
Exports of parts and components as a share of total exports (percent)



Source: UN COMTRADE.

c. Vertical integration with the global economy has increased

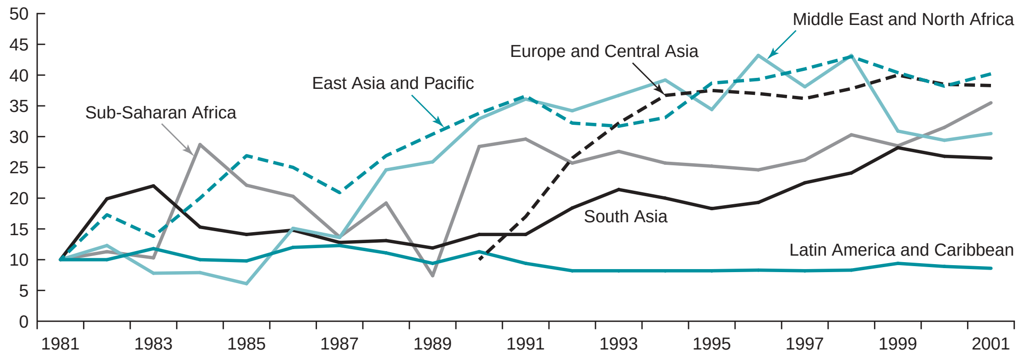
Import content of exports (percent)



Sources: Data from GTAP (ver. 6.03) and World Bank for 2001.

d. New products propelled export diversification

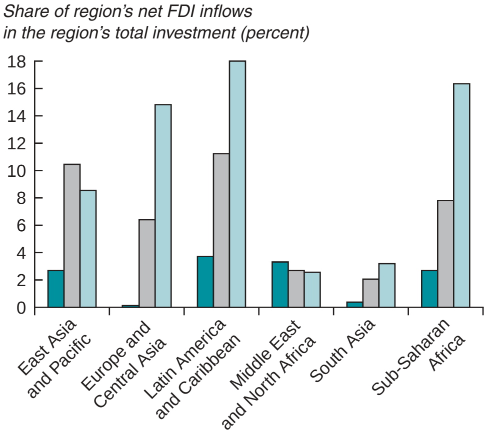
Share of 1980's bottom 10% of manufactured exports in total intra-regional exports



Source: UN COMTRADE.

Figure 2.5 (continued)

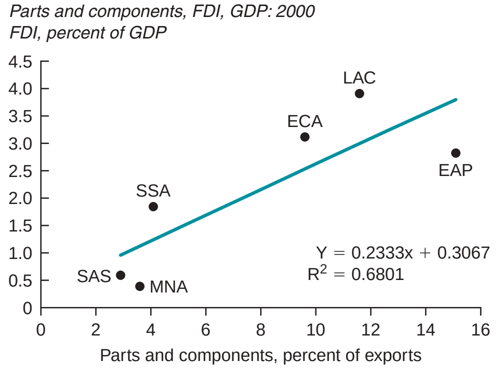
e. FDI flowed mostly into East Asia and Latin America



Note: Period averages for 1980–1989, 1990–1999, and 2000–2002 calculated from annual data. Both net FDI (BoP) and gross fixed capital formation are in current US dollars. For 1980–1989 in ECA, GFCF was estimated using a three-year average share of GFCF in GDP over the 1990–1992 time period and back-calculating GFCF from GDP for the entire 1980–1989 period. GDP time series (for 1980–1989 ECA only) obtained from UN national accounts.

Sources: World Bank, WDI.

f. A positive trend between FDI and parts exports for the regions



Sources: World Bank, WDI, and UN COMTRADE.

from developed countries embodied in imported intermediate inputs and backward linkages through exports. The magnitude of these links between increased trade in intermediates and productivity growth in developing countries has been studied in both cross-country analysis and country case studies.[13] While causation is difficult to establish, the evidence indicates that such links are important, and productivity growth associated with increased trade in intermediates is a potentially important source of growth.

Trade in new products

A large part of the expansion in exports in countries undergoing liberalization and successful trade expansion comes from products that were not traded—or minimally traded—prior to liberalization (see Kehoe and Ruhl 2002).[14] Growth in trade in new products may have the important advantage of allowing countries to escape the deterioration in the terms of trade that would come from trying to increase market share in existing products.[15]

To assess this phenomenon, we reviewed the trade performance of the least traded decile of product categories. In East Asia and Pacific, those products that figured in the lowest 10 percent of all EAP manufactured exports to the world in 1981 grew to almost 40 percent by 2001 (figure 2.5). For the other five regions, the performance of products among their lowest initial 10 percent was also noteworthy. Countries are building dynamic new markets for their existing exports and developing new variations of old products to replenish the product cycle. This trend is also associated with increased trade in intermediates; detailed analysis indicates that many of the new export goods are intermediate inputs. Increased trade in new products is thus part of the virtuous circle linking trade and growth.

Investment, handmaiden of trade

Foreign investment has been a driver of integration, increased trade in manufactures, and vertical specialization. As tariff barriers have come down in manufactures, market-seeking, horizontal FDI that once led the way in the import-substitution process has faded in importance relative to efficiency-seeking, vertical FDI that looks to locate segments of production in the lowest-cost site. This form of investment is associated with the rise in production chains and trade in components and parts.

FDI has increased as a share of GDP in all regions. This trend abated somewhat since the East Asia crisis in 1997–98 and the global recession of 2001–02, but FDI growth is likely to resume with the recovery of the global economy in 2004. East Asia and Latin America—the largest markets—have had and have retained by far the largest shares of FDI throughout the period (figure 2.5).

In East Asia and Pacific, the increase in FDI supported the pattern of segmentation and relocation of production processes within the region. In the 1990s, a large part of the FDI into Latin America was due to the privatization process the region underwent during this period. There is broad correspondence between FDI trends by region and the share of parts and components intermediates in regional exports.

Technology transfer from developed to developing countries is linked to trade, especially through trade in manufactures and intermediates, and also through foreign direct investment.[16] The better economic performance of East Asia and Pacific can be seen as resulting from the emergence of a "virtuous circle" or synergy between increased specialization in production, increased trade in intermediates, increased foreign investment, increased factor productivity, and increased growth. This region started earlier and appears more successful than other regions in achieving and sustaining this virtuous circle.

Preferential Trade and Regional Outcomes

Many historical factors, not just preferential trading arrangements, contributed to these trends. In the next chapter we provide a more detailed analysis of the impact of RTAs on trade. Here we simply highlight that the nature of RTAs and the context in which they have been applied have varied enormously across regions and that regional agreements often follow, rather than determine, changes in regional trade patterns. This suggests that preferential trade agreements are just one of many factors affecting trade outcomes and that when implemented in a highly restrictive economic environment, they are usually inconsequential.

History shapes trading patterns

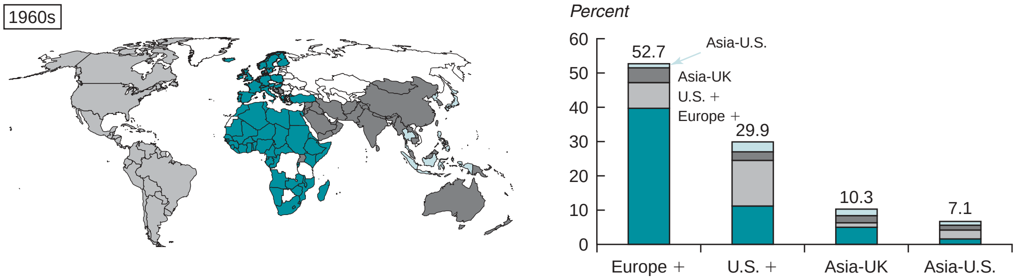
Differing regional performances in trade and growth have roots that go deeper than just boundaries on a map. Trade patterns—who trades with whom—have grown out of long political and economic histories that preceded the trends evident in the last two decades. The clusters of trading partners often bear little relationship to arbitrary definitions of regions (see Anderson and Blackhurst 1993, for an earlier analysis). Major trading blocs—that is, those countries that trade more with each other than with those outside their group—emerge from a cluster analysis. These blocs are not defined as traditional geographic political regions, but rather by statistical patterns in trade flows over decades.

The bipolar world of the 1960s

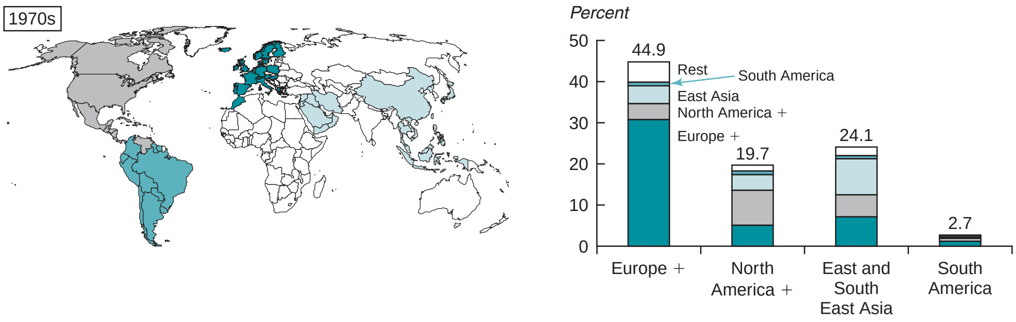
Coming out of the postwar period, the structure of world trade by the 1960s reflected a bipolar world, in which Europe and the United States had effectively formed blocs with some of their close neighbors, former colonies, and/or cold war partners; and with hub-and-spoke links to most of the developing countries. The two leading world trade blocs effectively accounted for 80 percent of global trade (figure 2.6). The European bloc was

Figure 2.6 Evolving trading blocs

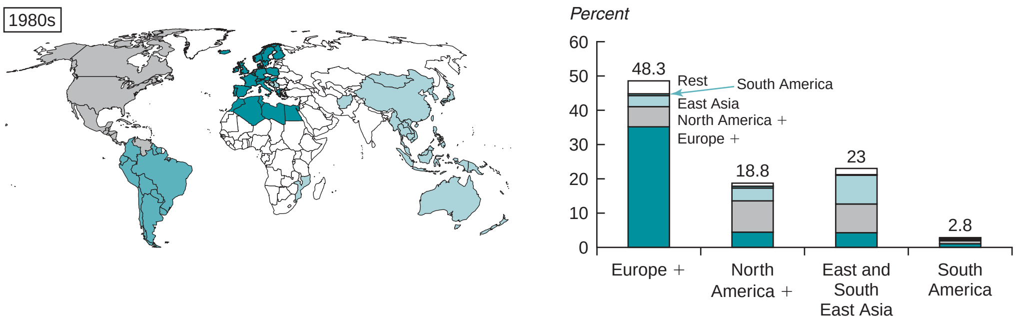
In the 1960s, the European Union and United States dominate trade . . .



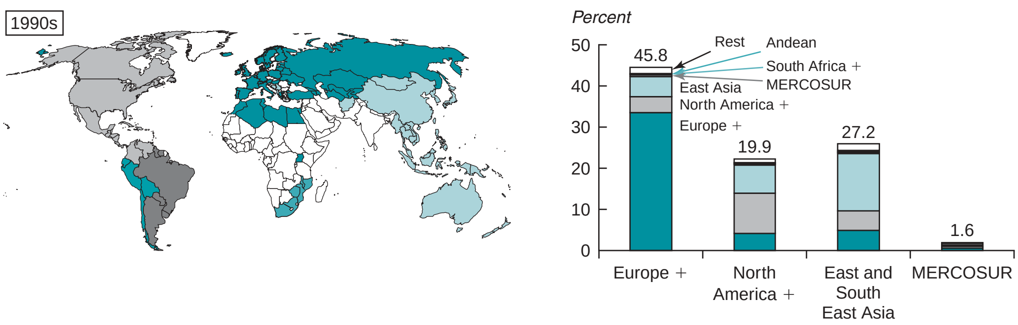
. . . but by the 1970s, Japan and Korea begin to lead an East Asian bloc . . .



. . . a decade later, the East Asian Tigers, ASEAN countries, and Australia consolidate the East Asia bloc . . .



. . . and in the 1990s, ECA emerges and East Asia trades more with itself than with the U.S. and EU.



Source: Robinson and Diaz Bonilla 2004.

closely linked with countries in Africa and former colonies. The United States was closely linked to Latin America.[17] Britain still retained leadership in a small Asian cluster consisting of former colonies, China, and the rest of the Middle East, much as the United States led a cluster of countries closely linked to the post-WWII political order in the Pacific—Indonesia, Japan, Korea, and Taiwan. The dependent developing countries traded much more with Europe or the United States, and not as much among themselves.

The realignment and the emergence of East Asia in the 1970s and 1980s

In the 1970s and the 1980s, a realignment of world trade began. The European and U.S. blocs fragmented in the 1970s, and their dominance dissipated to 65 percent of global trade. The East and Southeast Asian countries left the European bloc and effectively formed a new bloc (East Asia).[18] This bloc consolidated in the 1980s, increasing the share of within-bloc trade and expanded membership to include Australia and New Zealand. Its export share shifted toward the United States (36.2 percent in the 1980s compared to 26.4 percent in the 1970s). It also represented a growing share of total world trade—23 percent in the 1980s compared to 16 percent in the 1970s.

Consolidation and diversification in the 1990s

By the 1990s, earlier trends blossomed into a tri-polar world. One new element was the breakup of the Soviet Union and Moscow's central management of trade in Eastern Europe. Trading patterns began gravitating toward the EU. A second new element was the emergence of a new grouping: Argentina, Brazil, Paraguay, and Uruguay (i.e., MERCOSUR).[19] Finally, detailed analysis indicates a nascent bloc forming around South Africa, including the SACU countries.

These global trading patterns are revealing: First, today's tri-polar world of global commerce does not signify that the world is evolving into three disparate, autarchic trading blocs. To the contrary, trade among these blocs is intensifying, becoming more diversified, and linked with a web of business ties across oceans that bind the world market together. Second, in the 1990s, the emergence of new poles of commerce—MERCOSUR and South Africa—indicates that the process of segmentation and new bloc formation in world trade is still evolving. Third, it is clear that many of the emerging preferential arrangements have deep roots in historical trading patterns, but that some of the more recent bilateral FTAs are going beyond these historical patterns.

RTAs in different regions have different impacts

Patterns of regional integration tend to confirm the view that usually trade has preceded trade agreements. For *East Asia*, integration with the global economy was a strong impetus for regional integration. Exports to the world produced demand for imports from neighboring countries. As Korea matured and China opened, internal regional growth assumed its own dynamic. As a share of GDP, intra-regional trade in 2002 was 26.5 percent, twice as high as in the next highest region, yet regional trade preferences were very modest at best.

In fact, regional preferential trading arrangements followed rather than preceded this regional integration. The ASEAN Free Trade Area (AFTA), established in 1992, accelerated these tendencies and contributed to Southeast Asia's integration, but much of the tariff reduction has accompanied rather than preceded these patterns of regional integration. However, ASEAN leaders accepted in the Bali Declaration the need to pursue deeper integration and to create a single market to enhance the competitiveness of the region. The importance of preferential trade in the region was dramatically increased by the signing of a FTA between ASEAN countries and China.

Regional arrangements were critical for the successful integration of *Eastern Europe* into the world economy, but have not been as successful in the CIS countries. With the assistance of the EU in its Europe Agreements and with the aspiration of WTO membership, the Eastern European countries have moved swiftly toward integration. The CIS has been burdened with incomplete reforms, a poor investment climate, and a plethora of trading arrangements that have been implemented only partially. The combination has weighed down the subregion's performance.

In *Latin America*, the intra-regional share of exports in GDP in 2002 remains only one-fourth of East Asia's share. Since the 1960s, with the formation of the Latin America Free Trade Area (LAFTA), the region has struggled to expand trade. This proved futile as long as import substitution policies were in place and state enterprises were used as instruments of industrial policy. Early attempts in Central America and the Andean countries failed because of the inherent difficulty in managing potential trade diversion and location of industries within the regions behind high external protection barriers.[20]

This situation changed with the wave of unilateral reforms in the 1985–95 period. Mexico's reforms paved the way for the later creation of NAFTA in 1994, and reforms in Brazil and Argentina led to the creation of MERCOSUR in the same year. Similarly, the Central American countries, with a second go, managed to put in place a successful common market in the 1990s. As a result, intraregional regional trade has proceeded *pari pasu* with growth in the external markets.

In the *Middle East*, intra-regional trade has failed to gain dynamism. Because countries begin with broadly similar production and export structures, the scope for using regional trade to establish patterns of specialization and diversification in manufacturing production is limited. Intra-regional trade cannot be a substitute for extra-regional trade.

Several countries signed bilateral trade agreements with the EU as part of the Euro-Mediterranean agreements. Jordan and Morocco also signed agreements with the United States. All countries in the region entered into the Pan-Arab Free Trade Agreement and most participated in the sub-regional customs union, the Gulf Cooperation Council. Even so, these agreements have not been sufficient to overcome the effects of high border barriers and restrictions on services. The Euro-Med agreements with the EU have fallen short in their aspirations because of restrictions on trade in agriculture, services, and labor; lack of harmonization of standards; and stringent rules of origin.[21]

Regional agreements in *South Asia*, as with Latin America in the 1960s and 1970s, floundered on the shoals of high protection. The 1993 South Asia Preferential Trade Agreement (SAPTA) was stillborn, given continuing high levels of protection, a lack of meaningful concessions, domestic political problems, hostility between India and Pakistan, India's ban on imports of all consumer goods (from SAPTA countries until 1998 and from the rest of the world until 2001), and India's control over major primary goods (Baysan 2004).

Recently, however, unilateral trade reforms in India and Pakistan, political rapprochement, as well as concerns about rising preferential tariff arrangements in other parts of the world, led to the formation of the SAFTA Agreement in January 2004 (Newfarmer 2004).

In *Sub-Saharan Africa*, regional trade agreements are common and reflect an aspiration to overcome the limits that small sovereign states impose. These include SACU—one of the oldest customs unions in the world—CEMAC, COMESA, ECOWAS, and the East African Community. Although average applied MFN tariffs were cut by half between the 1990s and 2003, non-border barriers restrict internal trade. The recent regional trade agreements have had more impact on outward-looking MFN trade liberalization, and thus on external trade, than on intra-regional trade. The economic impact of these agreements appears to have been small, especially compared to pre-independence arrangements that essentially validated existing economic links (SACU, the West African

Economic and Monetary Union, and CEMAC). The EPAs under negotiation with the EU may reinforce this outward-looking pattern of trade integration, but the hope is that they will also aid Africa's own regional integration if they succeed in fostering economic reform and performance.[22]

The situation is different for agriculture and food products. Here margins of preference are more substantial in all regions except South Asia. The average margin of preference in the high-income region is similar to that in East Asia, Eastern Europe, and Latin America. Again, preferences are greatest in those regions showing the lowest degree of regional integration—the Middle East, and Sub-Saharan Africa.

Trade preferences have had very little impact on the high levels of intra-regional trade in manufactures in East Asia and Eastern Europe. Regions that offer substantial trade preferences behind high external barriers have not fared well in stimulating the growth of intra-regional trade.

Conclusion

Developing countries have increased their share of global trade as multilateral trade negotiations have led to sustained reductions in border protection for manufactured products. At the same time, and for a variety of reasons, the preferential trade agreements have proliferated. While the number of preferential agreements has increased rapidly, their trade coverage is substantially less than their official span of influence. Because many tariffs have come down close to zero, rules of origin restrict preferential access, and many products within agreements are excluded. Nonetheless, RTAs are leading to a more complex trading system and inefficiencies in customs administration; high tariffs in certain regions still risk significant trade diversion.

Notable differences are emerging between North-South bilateral agreements and South-South arrangements. North-South agreements are considerably more ambitious in content and coverage than South-South arrangements and reach deep behind the border to include services, protection of investment rules, and intellectual property rights.

In general, the wave of preferential trading arrangements followed—rather than preceded—an intensification of regional trade. Regions with the lowest external (MFN) border barriers ironically have developed the deepest intra-regional links and have been best positioned to diversify and exploit the emergence of global production chains in the manufacturing sector. East Asia is the starkest example, but Eastern Europe, in the wake of the dissolution of the Soviet Union, and Latin America, with the end of import-substitution industrialization, are not far behind.

What are the economic consequences of these arrangements? That is the subject of the next three chapters.

Notes

1. The recent accession of 10 new members to the European Union reduced the total number of RTAs in force from 285 to 229.

2. In fact there are only 12 countries that are not recorded as being party to a RTA, and many of these are small islands and principalities. The 12 are American Samoa, Bermuda, Channel Islands, Guam, Isle of Man, Monaco, Mongolia, N. Mariana Islands, Palau, Puerto Rico, Timor-Leste, and the Virgin Islands.

3. We are indebted to Gaspar Fontini of the European Commission's Directorate General for Trade for this formulation.

4. The U.S. Trade Representative is required to officially notify the U.S. Congress of its intent to negotiate FTAs.

5. See Weintraub (2004) and Schott (2004) for a more detailed discussion.

6. In the course of this discussion, the EU is treated as a single entity. For example, an EU-Mexico agreement is classified as bilateral.

7. The provision for regional cumulation in the rules of origin, particularly full cumulation, will tend to offset the hub-and-spoke system. See Brenton and Imagawa (2004). The EU, following substantial criticism of the hub-and-spoke system that emerged in Europe in the late 1990s, moved to create pan-European cumulation, although in terms of the more limited partial cumulation.

8. See Grether and Olarreaga (1999), who include GSP preferences but a smaller sample of countries.

9. In other words, 88 percent of intra-regional trade takes place among RTA partners.

10. This section benefited from the World Bank's regional chief economists at a workshop titled *Regionalism, Trade and Development,* May 5, 2004. Sadiq Ahmed, Harry Broadman, Alan Gelb, Homi Kharas, Mustafa Nabli, and Guillermo Perry made presentations that became the basis of this discussion.

11. The announced reforms were to reduce "supplementary duties" that were, in legal terms, additional to ad valorem tariffs; the economic effect is to reduce effective tariffs.

12. Hummels, Ishii, and Yi (2001) define an index of vertical specialization (VS). For direct effects for country k:

$$VS_k = \frac{\mathbf{uA}^M\mathbf{X}}{X_k}$$

where u is a 1 x n vector of 1's, A^m is the n x n imported coefficient matrix, X is an n x 1 vector of exports, n is the number of sectors, and X_k is the sum of exports across the n sectors. When indirect effects are added,

$$VS_k = \frac{\mathbf{uA}^M[\mathbf{I}-\mathbf{A}^D]^{-1}\mathbf{X}}{X_k}$$

the index becomes: , where I is the identity matrix and A^D is the n x n domestic coefficient matrix. Typically, given data limitations, measures of vertical specialization are imperfect. For example, a sector which produces both for exports and domestic markets, which is common given the aggregation available for sectoral data, is assumed to have the same production technology, particularly use of imported intermediates, for goods sold in either market. Even with these limitations, the measures provide a good picture of the changing role of trade in intermediates.

13. Winters (2004, 10–11) reviews the literature on links between trade in intermediates and productivity growth.

14. See Kehoe and Ruhl (2002). They present limited empirical evidence and then suggest a theoretical model that captures the phenomenon. Increased trade in new products is difficult to capture in standard models of world trade, so such models will tend to overstate terms-of-trade effects from changes in trade.

15. See Hummels and Klenow (2002).

16. Winters (2004) surveys work on the links between trade, productivity, and growth in developing countries. See also Nishimizu and Robinson (1984), and Esfahani (1991) who consider the links in semi-industrial countries. Schiff and Wang (2004) consider the link between TFP growth and regional trade links. Keller (2002) considers the mechanisms involved.

17. The definition of "closely linked" is countries that have such large trade shares with their bloc partners, particularly the United States and Europe, that adding them to the bloc increases the average within-bloc trade share.

18. Plus one region, "rest of Middle East and North Africa" (MENA), which is closely linked to Europe, but has significant trade with East and Southeast Asia.

19. The within-bloc trade share for MERCOSUR of 23 percent is lower than its trade share with Europe (27 percent), but given the increasing trend of its within-cluster trade share and the legal formation of MERCOSUR in 1995, it makes sense to designate it as a bloc. Latin American countries fall into three groups. One group is linked closely with North America, including RB de Venezuela, Colombia, and rest of Central America. The MERCOSUR countries define a second group, a trade bloc with diversified exports (a slightly higher share to the EU than to the United States). Finally, the third group is a heterogeneous collection of countries (Peru, Chile, and Other Andean Pact) with exports largely to the EU, partly to East and Southeast Asia, and with little trade among themselves.

20. IDB, Beyond Borders, 2002.

21. Chief Economist, MENA, 2004.

22. Chief Economist, Africa, 2004.

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